

## How Do the At-Risk Rules Apply to a Farm Business\*

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### Introduction

The majority of farm businesses will not be subject to the at-risk rules. However, when a business is subject to these rules, the deduction of losses will be limited to the amount that the producer has at risk. The amount at risk is the amount the taxpayer could actually lose from the activity. If the at-risk limitation rules do not apply, other rules such as the passive loss rules or the hobby loss rules could still limit loss deductions. The purpose of this article is to explain the at-risk limitations as they apply to both farm and non-farm business activities. The at-risk limitations will seldom affect either small farms or small-business owners. The tax effect of the at-risk rules can be unexpected, so it is important to have a basic understanding of the rules and visit with your tax advisor about your business and the at-risk rules to avoid surprises.

### Industries Included

The at-risk rules cover any trade or business activity, as well as any investment activity. The application of these rules is not limited to investments that produce portfolio income or loss (interest or dividends) or passive income or loss (rent). The limits on deductions apply to individuals, estates, trusts, and some closely held corporations.

Several business activities are subject to the at-risk limitation rules. Farming is one of these activities as defined in Internal Revenue Code Section 464:

*The term “farming” means the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity including the raising, shearing, feeding, caring for, training, and*

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*management of animals. For the purposes of the preceding sentence, trees (other than trees bearing fruit or nuts) shall not be treated as an agricultural or horticultural commodity.*

## Amount at Risk

The amount at risk for the producer includes money contributed to the activity plus debts for which the producer is personally liable. It also includes the fair market value of any property (adjusted for any liens) that is not used in the activity, but which the producer pledges as security for the debts of the activity, which is also at risk.

### Example 1:

Tom invests \$10,000 of his money in a vegetable production activity and pledges the value of the building that houses his accounting firm as security for the loan. The building has a fair market value of \$150,000 but has a secured lien of \$125,000. Tom's amount at risk in the vegetable production activity is \$35,000 (\$10,000 plus his \$25,000 [\$150,000-\$125,000] equity in the building).

**Note.** Having insurance will not render you "not at risk" for income tax purposes, even though the insurance does reduce the risk of a loss.

## Deductions of Losses

The deductions of losses from a trade or business activity, or an investment activity, are limited to the amount of investor's contribution at risk of loss. The losses that are greater than the amount at risk are then suspended and carried forward to a future tax year when there is an increase in the amount of the individual's contribution at risk. A producer's amount at risk can be increased or decreased in several different ways.

### Increasing the Amount at Risk

The following strategies can be used to increase the producer's amount at risk:

1. Contribute additional cash or property.
2. Allocate income produced by the venture to the individual. (This is the same income adjustment that increases basis for a partner or an S corporation shareholder.)
3. Refinance a loan, which changes it from a nonrecourse loan to a recourse loan. (This refinancing has no effect on adjusted basis in a partnership interest and is unlikely to affect an S corporation shareholder's basis in stock or debt.)

4. Use the gain recognized when the producer disposes of his or her interest in the activity to offset the suspended losses.

## **Decreasing the Amount at Risk**

The amount at risk is decreased by the following strategies:

1. An investor's withdrawal of cash or property from the activity.
2. A change in an investor's share of losses, such as refinancing of a recourse loan with a nonrecourse loan.

The amount at risk cannot be decreased below zero. If a taxpayer's at-risk amount is less than the amount of an item that would otherwise reduce the at-risk amount, then the amount in excess of the at-risk amount results in a recapture of previously deducted losses. The excess amount is then reported as income and the recaptured losses are added to the taxpayer's suspended losses.

## **Hobby Loss and Passive Loss Rules**

The at-risk rules may not limit deductions for many small businesses because the at-risk amount exceeds the losses from the business. However, if an activity is deemed to be a hobby or passive in nature, the hobby loss and/or passive loss rules may limit the losses. Please refer to other articles in this series to learn more about hobby losses and passive activities.

## **IRS Publications**

IRS forms and publications can be found by going to [www.irs.gov](http://www.irs.gov) and typing in the name of the publication/form or the publication/form number in the search bar toward the top of the webpage. Publications may be viewed online or downloaded.

Of particular interest on this topic:

- IRS Publication 925, Passive Activity and At-Risk Rules

## **Additional Topics**

This fact sheet was written as part of Rural Tax Education, a national effort including Cooperative Extension programs at participating land-grant universities to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets and additional information related to agricultural income tax please see [RuralTax.org](http://RuralTax.org).

Fact sheets that might be of interest include:

- Weather-Related Sales of Livestock
- Farm Losses versus Hobby Losses: How to Avoid Adverse Tax Consequences
- Materially Participate in the Business to Avoid the Passive Activity Loss Rules

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